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Current ESG Landscape and the Proposed SEC Rules

November 3rd, 2022

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RPCK understands that the terms environmental, social and corporate governance are becoming increasingly important to investors, investment advisors, legislators and regulators. This article is the first of a series of articles (i) related to the evolving ESG landscape and (ii) devoted to providing practical guidance for investment professionals operating in this space.

Introduction and Background.

Many registered funds and investment advisers to institutional and retail clients consider environmental, social, and governance ("ESG") factors in their investment strategies.[1] Investor demand for ESG funds and advisory services has increased over the last decade, but consideration of ESG issues in investment decision making is not a new concept.[2] In the 1970s and 1980s, some asset managers began to integrate ESG factors into funds with social and environmental investment objectives, the early 1990s saw the launch of the "socially responsible" indexes and a number of organizations have formed to promulgate disclosure reporting frameworks, including the Climate Disclosure Standards Board, Global Reporting Initiative, Sustainability Accounting Standards Board, and International Sustainability Standards

[1] See, the proposed rules (i) ESG Disclosures for Investment Advisers and Investment Companies (the "Proposed Rule") and (ii) the Amendments to the Fund "Names Rule", and the corresponding fact sheets "ESG Fact Sheet" and "Amendment to the Fund 'Names Rule' Fact Sheet", respectively. See also, SEC Press Releases: "SEC Proposes to Enhance Disclosures by Certain Investment Advisers and Investment Companies about ESG Investment Practices"; and "SEC Proposes Rule Changes to Prevent Misleading or Deceptive Fund Names".

[2] Proposed Rule at page 10.

Board[3]. These trends have accelerated in recent years and additional voluntary[4] and regulatory[5] frameworks have developed.

Alongside ESG, the terms corporate responsibility (CR), corporate social responsibility (CSR) and sustainability are sometimes used to refer to a broad range of environmental and social responsibility behaviors demonstrated by businesses. Similar to ESG, these terms vary in their definitions, use and applications. However, ESG is the term now often preferred by both investors and other stakeholders when using these types of factors to assess corporate behavior, evaluate the future financial performance of companies, and to evaluate investments and investment strategies.

ESG is an expansive term with three broad categories, defined as:

- Environmental: This includes climate change factors such as carbon emissions and vulnerabilities like stranded assets, but it also includes natural resources issues and investment opportunities like climate tech, cleantech, green building and renewable energy.
- Social: This includes diversity, equity and inclusion (DE&I), but it also includes supply chain labor standards, social opportunity and other issues.
- Governance: This includes corporate governance issues like board diversity and executive pay, and it can also cover corporate behavior such as business ethics and tax transparency.

Increase in demand ESG Products.

While ESG strategies have existed for decades, investor interest in these strategies has rapidly increased in recent years, with significant inflows of capital to ESG-related investment products and advisory services[6]. Investors and other market participants have increasingly demanded access to ESG-related investment services, products, and data.[7] Asset managers have responded to increased demand by creating and marketing ESG products.[8] The SEC's duo of proposed rules, discussed further below, are

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[3] See Murray, Sarah, "Measuring What Matters: the Scramble to Set Standards for Sustainable Business" (May 13, 2021). See also "IFRS Foundation Announces International Sustainability Standards Board" (Nov. 3, 2021).

[4] Proposed Rule at page 10. For example, the Greenhouse Gas Protocol: A Corporate Accounting and Reporting Standard ("GHG Protocol") that established measurable standards that allow investors to more readily compare the emissions impacts of companies in their portfolios and conduct scenario analyses. See "The Greenhouse Gas Protocol, A Corporate Accounting and Reporting Standard, Revised Edition". The Financial Stability Board ("FSB") established the Task Force on Climate–Related Financial Disclosures ("TCFD") in 2015 to develop a framework to foster consistent climate-related financial disclosures. See "Task Force on Climate-related Financial Disclosures, 2021 Status Report" (Oct. 14, 2021). In 2020, an international group of asset managers launched the Net Zero Asset Managers Initiative committing hundreds of signatories to the goal of achieving net zero gas emissions by 2050 or sooner. See "Net Zero Asset Managers Initiative Progress Report" (Nov. 1, 2021).

[5] In 2019, the European Commission adopted the Sustainable Finance Disclosure Regulation ("SFDR"), a sustainability disclosure framework for providers of certain financial products and financial market participants including asset managers. See "Regulation (EU) 2019/2088 of the European Parliament and of the Council" of 27 Nov. 2019 on sustainability-related disclosures in the financial services sector and "Regulation (EU) 2020/852 of the European Parliament and of the Council" of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088 PE/20/2020/INIT ("Taxonomy Regulation") (implementing a classification framework to help determine to what extent economic activities are environmentally sustainable by reference to six environmental objectives).

[6] ESG Fact Sheet.

[7] Proposed Rule page 12; See also Whyte, Amy, "More Institutions than Ever are Considering ESG. Will they Follow Through?", Institutional Investor (Oct. 6, 2020).

[8] ESG Fact Sheet.

to address the competitive pressures that may incentivize fund managers and advisers to act in improper ways to attract investor assets, including for example, over emphasizing certain ESG strategies, a practice known as “greenwashing”, or including certain ESG related words in a fund's name as a way to attract investor assets.

The ways that different funds and advisers define ESG varies widely. For one fund, ESG could mean excluding sin investments and for another it could mean prioritizing reductions in carbon emissions. Similarly, there are significant differences in the data, criteria, and strategies used as part of ESG strategies.[9] There is no consistent message regarding the extent to which ESG factors affect an investment decision and the extent to which these strategies are disclosed to investors. One fund may consider ESG as an overall umbrella strategy, while another fund may apply the strategy more broadly across each ESG category.[10] The lack of disclosure requirements and a common disclosure framework tailored to ESG investing make it harder for investors who seek to understand which investments or investment policies are associated with a particular ESG strategy.[11] Further, in the absence of informative disclosures, a fund’s or adviser’s disclosure could exaggerate its actual consideration of ESG factors, unbeknownst to investors.

As are result of the differences in ESG definitions, strategies and the lack of consistent disclosure obligations or disclosure frameworks, ESG has been viewed by some as a public relations and marketing ploy to attract investors, or as a new fad. These drawbacks have also led to certain myths about ESG that are harmful to the industry, including for example that ESG strategies perform poorly or that ESG assessments do not add value to investment process.

Although current US regulation exists to prevent false or misleading advertisements, by prohibiting material misstatements and fraud[12] and certain organizations that promulgate disclosure frameworks, as discussed above, the SEC recently proposed a duo of rules to squarely address issues in the ESG landscape.

SEC’s Duo; The Proposed Rules

On May 25, 2022, the SEC proposed amendments to rule and reporting forms both in the Investment Advisers Act of 1940 and the Investment Company Act of 1940 to promote consistent, comparable, and reliable information for investors concerning funds and advisers incorporate of ESG factors. The Proposed Rule and form amendments are designed to provide consistent standards for ESG disclosures, allowing investors to make more informed decisions as they compare various ESG investments.[13]

The proposed changes would apply to registered investment companies, business development companies, (“BDC”), registered investment advisers, and certain unregistered advisers. The rules and form amendments would enhance disclosure by: (i) requiring additional specific disclosure requirements regarding ESG strategies in fund prospectuses, annual reports, and adviser brochures; (ii) implementing a

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[9] Id.
[10] Proposed Rule at page 13.
[11] ESG Fact Sheet.
[12] For example, the Advisers Act Rule 206(4)-8 prohibits advisers to pooled investment vehicles from making false or misleading statements to existing or prospective investors in such pooled investment vehicles (e.g., investors in a registered investment company or private fund). See also the Marketing Rule, which prohibits advisers from advertising any untrue statement of a material fact, or omitting to state a material fact necessary in order to make the statement made, in the light of the circumstances under which it was made, not misleading.
[13] ESG Fact Sheet.

layered, tabular disclosure approach for ESG funds to allow investors to compare ESG funds at a glance; and (iii) generally requiring certain environmentally focused funds to disclose the greenhouse gas (GHG) emissions associated with their portfolio investments.[14] The transition period would be one year to comply with ESG disclosures in offering documents and regulatory filings and 18 months for shareholder and annual reports.[15]

While "ESG" is commonly understood to describe the categories: "Environmental", "Social", and "Governance", the SEC is proposing leave these terms undefined, but instead require disclosure to investors on how ESG factors are specifically incorporated into their investment selection processes and investment strategies.[16]

The proposal would require funds that consider ESG factors in their investment process to disclose additional information regarding their strategy, where the amount of required disclosure depends on how central ESG factors are to a fund’s strategy. Due to the amount of information that could be required to appropriately disclose an ESG strategy, the disclosure would follow a “layered” approach with a concise overview in the prospectus supplemented by more detailed information in other sections of the prospectus or elsewhere in other disclosure documents.[17]

The proposal identifies the following three types of ESG funds:[18]

1. Integration Funds. Funds that integrate ESG factors alongside non-ESG factors in investment decisions would be required to describe how ESG factors are incorporated into their investment process.
2. ESG-Focused Funds. Funds for which ESG factors are a significant or main consideration would be required to provide detailed disclosure, including a standardized ESG strategy overview table.
3. Impact Funds. A subset of ESG-Focused Funds that seek to achieve a particular ESG impact would be required to disclose how it measures progress on its objective.

Advisers that consider ESG factors would be required to make generally similar disclosures in their brochures with respect to their consideration of ESG factors in the significant investment strategies or methods of analysis they pursue and report certain ESG information in their annual SEC filings.[19]

The Proposed Rule would require additional disclosures from ESG-Focused Funds (and as subset of ESG-Focused Funds, also Impact Funds) regarding GHG emissions, carbon footprint and weighted average carbon intensity of their portfolio.[20]

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[14] Id.
[15] Proposed Rule at pages 168 and 169.
[16] The Proposed Rule at footnote 6 notes, "For the purposes of this release and the proposed rules, the Commission uses the term “ESG” to encompass terms such as “socially responsible investing,” “sustainable,” “green,” “ethical,” “impact,” or “good governance” to the extent they describe environmental, social, and/or governance factors that may be considered when making an investment decision. These terms, however, are not defined in the Advisers Act, the Investment Company Act, or the rules or forms adopted thereunder." See also the Proposed Rule at pages 13 and 14 as well as footnote 22.
[17] Proposed Rule at pages 23-24, 27.
[18] Proposed Rule at pages 26, 33-37.
[19] ESG Fact Sheet.
[20] Id.

Changes to the Names Rule

The Second proposed amendment is to Rule 35d-1 under the Investment Company Act of 1940, the fund "Names Rule," which has not been amended since its adoption over 20 years ago.[21] The Names Rule helps ensure that a fund's name accurately reflects the fund's investments and risks.[22] This amendment would further serve the SEC's mission of investor protection by: (1) improving and expanding the current requirement for certain funds to adopt a policy to invest at least 80 percent of their assets in accordance with the investment focus the fund's name suggests; (2) providing new enhanced disclosure and reporting requirements; and (3) updating the rule's current notice requirements and establishing recordkeeping requirements.[23]

The Names Rule as currently in effect requires funds with certain names to adopt a policy to invest 80 percent of their assets in the investments suggested by that name. The SEC amendments would expand this requirement to apply to any fund name that suggests a focus on investments or issuers with particular characteristics. This would include, for example, fund names with terms such as "growth" or "value", but also those indicating that the fund's investment decisions incorporate one or more environmental, social, or governance ("ESG") factors.[24] Fund's with names that include "global" or "international" as well as "income," were previously outside of the 80% requirement. Further, to address the rule's application to derivatives investments, the proposal would require a fund to use a derivatives instrument's notional amount, rather than its market value, for the purpose of determining the fund's compliance with its 80 percent investment policy.[25]

Whereas the Names Rule currently only applies "under normal circumstances" and at the time of investment, the SEC specifies in the proposed amendments the particular circumstances under which a fund may depart from its 80 percent policy, such as sudden changes in market value of underlying investments, including specific time frames for returning to compliance.[26]

Under the proposed Name Rules, a fund that considers ESG factors alongside but not more centrally than non-ESG factors in its investment decisions, would not be permitted to use "ESG" or similar language in its name. Doing so would be defined to be materially deceptive or misleading. For such "Integration funds" the ESG factors are generally no more significant than other factors in the investment selection process, such that ESG factors may not be determinative in deciding to include or exclude any particular investment in the portfolio.[27]

Key Takeaways

If adopted, the new proposed regulations and disclosure requirements will affect the operations of asset and investment management firms and the companies behind the assets they manage. This poses interesting opportunities and challenges for asset managers as intermediaries.

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[21] SEC Press Release: "SEC Proposes Rule Changes to Prevent Misleading or Deceptive Fund Names".
[22] Amendment to the Fund "Names Rule" Fact Sheet.
[23] Id.
[24] Id.
[25] Id.
[26] Id.
[27] Proposed Rule at footnote 47.

SEC Commissioners have spoken candidly of the need to impose consistent standards to assist investors in making their investment decisions and also to prevent funds from exaggerating the extent to which they consider ESG factors.[28] Accordingly, it is likely that some form of the Proposed Rule and amendments to the Names Rule will take effect.

Therefore, to the extent funds and investment professionals that consider ESG factors have not done so already, they should begin to consider the practical operational implications of these proposed disclosure requirements, including, for example, (i) developing ESG strategies and disclosure procedures, ensuring investment practices are consistent with the disclosures, and (ii) evaluating their fund names to ensure 80% compliance with the new requirements.

In our next set of articles, we will continue to explore the types of ESG funds and their corresponding disclosure requirements, and we will also discuss the EU approach to ESG, as ESG has gained momentum across the world.

[28] *Comm'r Allison Herren Lee*, Shelter from the Storm: Helping Investors Navigate Climate Change Risk (Mar. 21, 2022); *Comm'r Caroline A. Crenshaw*, Virtual Remarks at the Center for American Progress and Sierra Club: Down the Rabbit Hole of Climate Pledges (Dec. 14, 2021); and *Comm'r Allison Herren Lee,* A Climate for Change: Meeting Investor Demand for Climate and ESG Information at the SEC (Mar. 15, 2021).↩